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SOME ACCOUNTING PROBLEMS *of the* SECURITIES *and* EXCHANGE COMMISSION

SOME PROBLEMS OF ADMINISTRATION *of the* STATE INCOME *and* UNINCORPORATED BUSINESS TAX

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AMBIT *of the* DUTIES *and* RESPONSIBILITIES *of the* CERTIFIED PUBLIC ACCOUNTANT

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"To cultivate, promote and disseminate knowledge and information concerning accountancy and subjects related thereto; to establish and maintain high standards of integrity, honor and character among certified public accountants; to furnish information regarding accountancy and the practice and methods thereof to its members, and to other persons interested therein, and to the general public; to protect the interests of its members and of the general public with respect to the practice of accountancy; to promote reforms in the law; to provide lectures, and to cause the publication of articles, relating to accountancy and the practice and methods thereof; to correspond and hold relations with other organizations of accountants, both within and without the United States of America; to establish and maintain a library, and reading rooms, meeting rooms and social rooms for the use of its members; to promote social intercourse among its own members and between its own members and the members of other organizations of accountants and other persons interested in accountancy or related subjects; and to do any and all things which shall be lawful and appropriate in furtherance of any of the purposes hereinbefore expressed."

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THE NEW YORK STATE SOCIETY OF
CERTIFIED PUBLIC ACCOUNTANTS

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Some Accounting Problems of the Securities and Exchange Commission

By Carman G. Blough

THE wide distribution of corporate securities, the inability of the vast majority of investors to judge the value of their investments by any close-range view and their dependence upon information contained in published financial statements has placed a great responsibility upon the accounting profession. The Securities Act and the Exchange Act, because of the liabilities imposed thereby, have brought this fact home more forcibly than ever before although the responsibility of the profession has existed ever since businesses have offered their securities to the public.

Since sound and informative accounting statements are basic under each of these Acts, the part played by the accountant in their administration is extremely important and much dependence is placed upon the results of his work.

Many of you have expressed the belief that the Securities and Exchange Commission is in a position to make substantial contributions in the direction of more uniform accounting practices and more general acceptance of sound accounting principles, and when we note the number of occasions writers on accounting and financial subjects find for referring to the attitude of the Securities and Exchange Commission with respect to accounting matters, we can not fail to be impressed with the seriousness of the responsibilities with which the Commission has been charged. This is a challenging opportunity but the anticipated results can be realized only if the members of the profession and the Commission work together in the formulation and execution of sound policies.

In approaching the solution of the accounting problems confronting it under the Securities and Exchange Acts, it seems to me the Commission had several lines of action open to it. First, it might have attempted to lay down definite rules and regulations relating to accounting matters to be followed by all persons registering securities with the Commission. To have followed this procedure would have been virtually impossible, even if it had not been undesirable. The ramifications of accounting are so extensive that to have attempted to follow this procedure would have been a super-human task and could not have resulted other than in the formulation of a series of regulations which, in many instances, would, undoubtedly, have been premature or unsound.

Second, the Commission might have adopted a positive position upon each accounting question as it arose, thereby establishing a principle to

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govern subsequent cases. This also would have been subject to the same weaknesses as the procedure previously mentioned.

Third, the Commission might have undertaken to study each registration statement with a view to having the financial data presented in such a manner as the Commission might deem preferable in the individual case. Such a procedure would have led to inconsistencies, detracted from the comparability of statements and only added to an existing lack of uniformity in accounting procedure.

A fourth course was that of studying the individual statements to determine whether the methods followed in their preparation are generally recognized and if not, to cause the statements to be amended in accordance with generally accepted principles. It is this approach that the Commission has chosen to follow in the belief that it constitutes the most practicable procedure.

Consistent with this policy, the Commission has refrained, as far as possible, from prescribing specific rules relating to the presentation of accounting matters and statements may, for the most part, be filed in such form and using such generally accepted terminology as will best indicate their significance and character.

Since most of the required financial statements must be certified by independent public or independent certified public accountants, the practical effect of this provision is to leave the responsibility for the way in which the presentation is to be made, with certain expressed limitations to the certifying accountant.

The suggested forms of financial statements incorporated in the several instruction books are given as guides, not as hard and fast rules. For example, the fact that they show the assets and liabilities classified in the order of current to fixed does not prevent the accountant from classifying them in the reverse order if that will best present the facts with respect to the particular registrant. Losses on sales of securities are shown as income deductions but that should not govern the method of treating such losses by a company engaged in the business of buying and selling securities.

There are, however, certain specific accounting requirements in the forms. They are not startling or original. They simply express principles followed by the better accountants. For example, even if the forms had not so required, most accountants would not consolidate with the accounts of the registrant those of subsidiaries in which the registrant does not own more than 50% of the voting control; would not include items not realizable within one year among current assets; would designate current assets or securities pledged to secure liabilities; would show separately and deduct from the specific assets to which they apply, any reserves provided against current assets; would exclude notes and accounts, known to be uncollectible, from both the asset and the reserve; would state separately amounts due from officers

and directors, other than trade accounts subject to the usual trade terms; would state separately any long-term debt falling due within one year; would reveal contingent liabilities in footnotes; would state separately with explanation, any substantial non-recurring items of other income or income deductions; etc. Unfortunately, however, not every accountant is as meticulous in such details as we might wish.

One of our requirements is that the certification shall state the opinion of the accountant with regard to the financial statements of, and the accounting principles and procedures followed by, the registrant. The precedent for this is to be found in the form of accountants' reports developed by the correspondence between the Special Committee on Cooperation with Stock Exchanges of the American Institute of Accountants and the Committee on Stock List of the New York Stock Exchange.

Compliance with this provision should not be unduly difficult. If the registrant's accounts have been kept in accordance with generally accepted accounting principles, that fact should be stated. If they have not been so kept, that fact should be brought out. Even though the statements presented by the accountant have been drawn to reflect accepted principles, it is quite important for the investor to know the customary accounting policies of the registrant and its subsidiary companies. Such policies reflect the likelihood of integrity in the accounts during periods prior to those under review and they also reflect the attitude of the corporate officials.

The fact that the accountant finds it necessary, at the time of his audit, to make routine adjustments correcting minor errors in accounting procedure should not prevent him from stating that the accounts of the client have been kept in accordance with accepted principles of accounting consistently maintained, but if the client's customary procedure is to deliberately record transactions in such a manner as to violate accepted principles or if isolated items of major importance have been improperly handled, that fact should be stated. In any event the accountant should express his opinion as to whether the accounting statements properly reflect the financial condition of the company and the results of its operations and if they do not, he should state wherein they do not.

Because of the lack of agreement among accountants with respect to important accounting principles, it has been difficult to determine what position should be taken with respect to many of the statements filed with the Commission in which such controversial questions have been involved. A great many questions presented to us must be settled immediately. In many instances, we hesitate to take a position in favor of what we believe to be the best practice because there is no time for extensive research and consultation with leaders in the field and because we find that reputable and highly-thought-of practitioners have followed contrary procedures. In numerous instances where we believed the methods of accounting to be improper,

we have accepted complete revelation of significant matters instead of insisting upon a revision of accounting statements as we would have if there had been a violation of an unquestionably accepted accounting principle. For example, we would not hesitate to require a company to amend its statement if it had included Government bonds under the heading of "Cash", notwithstanding the fact that one accountant argued vociferously that such a procedure was proper. On the other hand, if the question involved the treatment of treasury stock, we might have the opinion that such stock was improperly shown as an asset on the balance sheet; yet the fact that there is substantial precedent for including it as such rather than as a deduction from capital and surplus might be sufficient reason for us to accept the balance sheet in which treasury stock was so shown, provided it was set out separately and the number of shares so held, together with their cost and possibly their par or stated value, were clearly indicated.

Often, the principles with respect to which there is marked difference of opinion among accountants are such that in order to make the statements not misleading, it is necessary that voluminous notes be attached thereto. Apropos of this, in a recent issue of The Journal of Accountancy, a prominent member of your Society made the statement that "while explanatory footnotes are sometimes necessary, an accountant has not lived up to his full professional obligation if he accepts an unsatisfactory method, explained in a footnote, in any case in which by the exercise of courage and persuasion he might have brought about the adoption of a more satisfactory method which would have rendered the footnote unnecessary." Certainly the Commission would prefer that financial statements be so prepared as to eliminate the necessity for extensive footnotes.

In the course of our work, we have occasion to see a wide variety of procedures followed in the treatment of almost every conceivable kind of an accounting problem. The term "generally accepted accounting principles" has been widely used in accounting literature, particularly by the American Institute of Accountants and the Securities and Exchange Commission; yet I do not know of any satisfactory definition of the term. A principle in some fields of knowledge is a fundamental concept universally accepted by persons in the particular field; in others, it may be considered as a rule of action. When we modify principle by the words "generally accepted", there is an inference that there may be principles not generally accepted. This seems to place accounting in a class where principles are not immutable laws but rules of action. Accordingly, it would seem that the proper interpretation to give to the term "generally accepted principle", in the field of accounting is that it is a procedure for handling the recording and interpretation of a particular type of business transaction so extensively followed that it may be considered to be generally accepted. If this is a proper interpretation of the term, I am very much afraid it is difficult to name very many principles that are generally accepted.

Almost daily, principles that for years I had thought were definitely accepted among the members of the profession are violated in a registration statement prepared by some accountant in whom I have high confidence. Indeed, an examination of hundreds of statements filed with our Commission almost leads one to the conclusion that aside from the simple rules of double entry bookkeeping, there are very few principles of accounting upon which the accountants of this country are in agreement.

In this connection, the question may well be asked, "Are the terms 'generally accepted accounting principles' and 'sound accounting principles' synonymous?" Reluctant though I am to express such an idea, I have been forced to the conclusion that procedures so generally followed among accountants as to constitute substantial precedent are not always fundamentally sound. In such cases, I think the fault is in their historical development. Many accountants would probably question the soundness of certain principles that they follow from day to day if they stopped to consider them, but, in many cases, they follow the precedent of other accountants or the opinions of recognized authorities in whom they have confidence without reasoning the problem through to their own satisfaction.

You all know how precedents of this kind may become established. An accountant has a peculiar situation that he thinks may best be treated by some digression from what he himself considers to be the best practice under normal circumstances. Again a very positive and valued client has taken a position contrary to the accountant's best judgment but, in the particular case, the accountant, because he thinks the principle at stake is not sufficiently important to cause him to withdraw, accedes to the wishes of his client. After a few cases of this kind by reputable firms, some accountant, hurried in a job, accepts such precedent without giving careful thought to the problem. Subsequently, some textbook writer relates the practice as an example of a procedure followed in some instances and this is, in turn, cited by others in support of the practice. Thus a large body of precedent is established for a procedure that was first reluctantly undertaken as an exception.

The extent to which a particular practice is "generally accepted" is hard to measure. It is virtually impossible to take the various practices with respect to the same kind of transaction and weigh them against each other to determine which is the most generally accepted. Those who depend upon precedent are usually content with finding a number of cases to support their position without substantial effort to ascertain the extent to which other practices are followed.

In explaining the foregoing, a few specific cases may be helpful.

One of the first problems that occurs to me, possibly because as I write this I have been interrupted to consider the matter, relates to the treatment on a balance sheet of assets for which a 100% reserve has been

provided. The particular case is one in which patents that expired four years ago, and which had been fully amortized during their life by the creation of a reserve, were still carried in the balance sheet along with unexpired patents. The total cost of these patents was shown short on the asset side from which was deducted the full amount of the depreciation reserve, the net book value of the patents being carried out in the asset column. Is this in accordance with sound accounting principles? My own opinion is that it is not and I also question whether it is in accordance with generally accepted accounting principles. The same question might be asked in connection with a statement in which depreciable property is carried at cost with a full deduction for the reserve. The argument has been advanced, with good reason, that if the property is still used and useful in the business, it is not improperly shown in that manner but if it has been abandoned or scrapped, it is entirely improper for it to be included. Following that reasoning, it was argued, in the patent case just mentioned, that the company is still making profits through the use of improvements to the expired basic patents so that their cost might still be shown on the balance sheet even though fully amortized.

While we are on the subject of patents, I should like to raise a question with respect to the principle that should be followed in connection with the writing off of the excess purchase price of an investment in a subsidiary which was paid because the subsidiary owned valuable unexpired patents carried on its books at a nominal amount at the date of the acquisition of its stock by the parent company. Textbook writers and general accounting literature appear to regard the investment of a parent in its subsidiary as a cost figure that should not be amortized. Is there any generally accepted principle of accounting that would require the excess investment attributable to patents to be amortized over the life of the patents? Whether there is or not, my own opinion is that sound accounting principles would so dictate and I have taken that position in connection with a registration statement although the accountant in this case, a reputable one, was of the opposite opinion.

This same problem arises in any case in which the excess price paid by a parent for a subsidiary's stock is due to the fact that depreciable or wasting assets are carried on the books of the subsidiary at less than the value attributed to them by the parent company in the acquisition of the stock. In such a case, it would seem to me that the parent's investment in the subsidiary should be written off as the property values are depreciated or depleted in order that the parent should not reach a point where it would hold investments in the subsidiary at large values represented only by depreciated or depleted properties.

When we open up the question of consolidation, we find a great many problems for which it is difficult to point out generally accepted procedures. Various questions arise in determining whether a subsidiary should be

included or excluded from a consolidated statement. In view of existing unstable international monetary exchange, is it desirable to consolidate foreign subsidiaries? If they are included, the reader of the statement has no way of appraising the results of a fluctuation or an anticipated fluctuation in exchange rates between the date the statement is drawn and the date it is read, which, since they are no longer limited to the gold points, may be very significant.

If the fluctuation in exchange rates does not prevent consolidation of a foreign subsidiary, should it be consolidated if it is located in a country that places restrictions upon the export of funds? Would it not be seriously misleading, at the present time, for example, to consolidate a major subsidiary located in Germany? How much of the net income of that subsidiary can be considered income accruing to the benefit of the American company's security holders?

Should a subsidiary in reorganization under Section 77B of the Bankruptcy Act be consolidated? If it is in bankruptcy, there would seem to be little doubt but that it should be excluded although this is by no means universally done. In case the subsidiary is not in bankruptcy, however, there is considerable difference of opinion as to whether it should be included or excluded. When there are to be material changes in equities, or control may be lost, it would seem desirable to exclude them.

To what extent should companies of a nature widely differing from the parent be included in consolidation? Should a public utility include in its consolidation the affairs of a manufacturing company, or a steel company the affairs of a lumber company, or an automobile manufacturing company the affairs of a taxicab company simply because of a controlling interest? If so, to what extent does a statement with such varied inclusions lend itself to analysis? Can one judge properly the affairs of the steel business when the figures include unrevealed amounts that must be judged in the light of the lumber business? Of course, the assets, liabilities, income and expenses of the important subsidiaries must be considered in connection with those of the parent company in order that the value of the parent's securities may be determined. However, these may be obtained from separate statements.

With respect to subsidiaries not included in consolidation, writers seem to be quite uniform in expressing the opinion that the equity of the parent company in the undistributed gains or losses of unconsolidated subsidiaries, as well as the parent's equity in their surplus or deficit accumulated since they were acquired, should be clearly disclosed; but generally accepted practice, if it is to be judged by the number of statements drawn in which this is not done, seems to deviate somewhat from the expressed principle.

In this connection, what is the accepted principle to be followed by a parent in accounting for profits and losses of its subsidiaries? Practice

seems to be pretty well divided between taking up the profits and losses of subsidiaries by adjustments to the investment account and taking up only the dividends declared by the subsidiaries. Of those who advocate taking up only the dividends, some provide for losses of the subsidiaries while others do not. If the profits and losses of subsidiaries are to be taken up, is it proper to follow the same procedure when the company whose stock is owned is not controlled? We have had at least one instance in which a well-known accounting firm approved the procedure of a registrant in taking up its share of the earnings of a company in which it owned exactly 50% of the stock although it disclaimed any control.

There is a great deal of accounting precedent for a parent to take up on its own books profits on sales to its subsidiaries at the time of the sale even though the goods sold remain in the subsidiaries' inventories or fixed capital accounts at the end of the accounting period. The discussions relating to the requirement that intercompany profits should be excluded seem to be devoted entirely to the problem as it relates to consolidated statements. Suppose a parent sells at a profit a considerable part of its output to its subsidiaries which use the goods so purchased as fixed assets in their own businesses. We had such a case recently. Under these circumstances, it would seem that either the profit on the sales to subsidiaries should not appear on the parent's statement or consolidated statements should be presented, in which case intercompany profits would be eliminated.

A principle of consolidation I had thought to be well established is the one governing the elimination of a parent's investment in a subsidiary against the capital stock and surplus of the subsidiary. I had always believed, and still do, that the proper basis for elimination is the value shown by the subsidiary's books at the date of acquisition. Of course, if the parent company has followed the practice of taking up the profits and losses of its subsidiaries, the basis of elimination is somewhat different but the excess to be accounted for should still be the same as it was at the date of acquisition. It is, therefore, quite disturbing to me to see the number of accountants who have eliminated the par value of the subsidiaries' securities without regard to their book value at the date of acquisition.

Another practice in connection with consolidated statements that I had always thought to be universal is that of showing the assets and liabilities on the consolidated balance sheet at the aggregate amounts of the assets and liabilities of the consolidated companies after elimination of all intercompany accounts. Yet one of the largest accounting firms in the country certified to a statement not long ago in which the minority interest in the assets and liabilities of the subsidiaries was eliminated so that no minority equity appeared in, and the minority's share of the assets and liabilities was excluded from, the consolidated balance sheet.

Some very troublesome problems arise in connection with the separation of paid-in surplus, other capital surplus and earned surplus. Leading pro-

nouncements in the field of accounting have taken the general position that capital surplus should not be used to relieve the income account of the current or future years of charges that would otherwise be made against income. Yet, it has been quite amazing to see the number of occasions that accountants have found for writing off against capital surplus items that, according to my standards, can properly be handled only through the income account or directly against earned surplus.

The position has generally been taken that where earned surplus deficits have been wiped out by transfers of capital surplus, the earned surplus should be so designated as to show the date of the beginning of the existing earned surplus. Also, when the write-offs are made pursuant to a reorganization, there appears to be no serious objection to their being charged against capital surplus even though the result is to relieve future income accounts of proper charges. In such cases, however, it is generally considered that the earned surplus should be exhausted before any charges are carried to capital surplus and subsequently earned surplus should be dated. The difficult part of this question is to determine when there really has been a reorganization. It would not seem necessary to go through bankruptcy proceedings under the Bankruptcy Act to be reorganized although some writers advocate statutes requiring court approval of all reorganizations. If there has been a general scaling down of assets and a readjustment of capital stock through action of the stockholders with the avowed purpose of reorganizing the company's capital structure, it may be proper to consider that a reorganization has taken place. On the other hand, an action of the board of directors in writing off capital assets with a view to reducing future depreciation charges should certainly not, in my opinion, be considered a reorganization. Some companies have scaled down their assets due to the general change in the price level and have taken the adjustment through capital surplus. They support this action by the claim that the loss was a capital one—therefore properly taken against capital surplus. Accountants have differed very materially on points of this kind.

The desirability of using surplus arising through *appreciation* to write off operating deficits, though there seem to be many who support that practice, appears to me to be very questionable and the use of surplus created by the appreciation of one class of assets to revalue other assets downward is to me untenable. Yet one of our largest and best-known accounting firms specifically stated in a statement filed with our Commission that this was in accordance with accepted accounting practice.

Under what circumstances, if any, is it proper to write down assets when the effect of the write-down will be to reduce charges to income in future years? We have some fairly extensive pronouncements, as I have previously mentioned, against the practice of using capital surplus to relieve future earnings, but what about using earned surplus to do so? Suppose a company writes off a substantial amount of the cost of its property, or the

cost of patents, or bond discount and expense against earned surplus created through income of previous periods. Is it acceptable accounting practice? It results in a conservative statement of the assets but it also results in a reduction of expenses and the commensurate increase in net income for future periods. Here again, there seems to be no consistent practice among accountants which could be pointed to as generally accepted. Many, while expressing the belief that it might have been preferable to amortize the assets, seem to find nothing to criticize and, in fact, some very vigorously uphold the practice of writing them off.

Another subject in which lack of uniformity of accounting practices continually raises difficult questions is the proper balance sheet presentation of capital stock. How, for example, should reacquired stock be treated? Should it be shown as an asset, should it be deducted from the capital stock or surplus accounts or should it be deducted from the combined capital stock and surplus? Recent literature on the subject, including the "Tentative Statement of Accounting Principles" by the American Accounting Association and the "Examination of Financial Statements" by the American Institute of Accountants, expresses the thought that the cost of reacquired shares of stock, which are reissuable, should be regarded as an unallocated deduction in surplus rather than as an asset. Yet we find a very large number of companies, whose statements are certified to by well-known accountants, that include reacquired stock among the assets. Our rules require registrants to state their reasons for so doing when they follow this method of presentation. The reasons given are many and vary all the way from "general corporate purposes" to "required for fulfillment of stock-purchase contracts."

Another troublesome problem is involved in the treatment of preferred stock having liquidating value very much above its stated or par value. For example, we had a case not long ago involving a company having preferred stock with a par value of $1.00 per share and a liquidating value of $50.00 per share. The stock had been sold for $50.00 per share. At the time of the sale, $1.00 was carried to capital stock and $49.00 to capital surplus. Capital surplus had been legally created and was available for dividends, but on the preferred stock only. What, if any, is the acceptable manner of showing these facts on the balance sheet? Various methods have been followed in registration statements filed with the Commission.

Another subject which might be commented upon is that of installment sales. Accounting literature has, I think, been considerably affected by the necessity of devising accounts to meet the requirements of the Internal Revenue Acts. Long treatises may be found on the deferring of profits on installment sales, etc.; but it is questionable whether these apply to the presentation of financial data for other than tax purposes. Very few companies filing registration statements make any attempt to defer income or to segregate installment sales or the profit on installment sales from their other business. What should be considered good accounting practice in this respect?

What generally accepted principle governs the treatment of unexpired bond discount and expense on a refunded issue and the premium on the call of such refunded bonds? These items are handled in a variety of ways; some charge them directly to surplus; others amortize them over the unexpired life of the old bonds while still others amortize them over the life of the new bonds. While writing them off immediately to surplus is undoubtedly the most conservative procedure, there seems to be justification for writing such amounts off over the unexpired life of the old bonds provided this does not make the annual charge for interest, discount and expense greater than it was on the old bonds. If by following such a procedure, the charge becomes greater than it would have been under the old bond issue had the bonds not been refunded, I think an amount should be written off directly to surplus sufficient to cut down the annual charge at least to a figure no greater than it would have been under the old bonds. It does not seem proper to defer any of the expense attributable to the old bonds to a period beyond their unexpired life, notwithstanding the fact that this appears to be a common practice, because it is impossible to determine that such periods gain any advantage out of the refinancing. Whether they do or not will depend entirely upon the general market conditions and the interest rates at the date the old bonds would have expired.

In this connection, it might be appropriate to mention the procedure to be followed in handling duplicate interest charges in a refunding operation. For example, suppose it is proposed to refund one or more outstanding issues with one new issue. It may be possible that it will be necessary to issue the new bonds quite some time before the earliest call date on one or more of the issues being retired. In some cases this duplicate interest has been charged to income immediately; in others, it has been included with bond discount and expense for subsequent amortization. In the latter case, some have deferred the interest on the new bonds, charging the interest on the old bonds to expense, while others have deferred the interest on the old bonds and charged the interest on the new bonds to expense. Where there is a material difference in such interest rates, the variation may be significant.

Another question of considerable importance is the proper treatment of profits and losses on the sale of portfolio securities by an investment trust. Some of the companies who carried these profits through the profit and loss account during the prosperous days ending with 1929 subsequently decided that profits or losses from such transactions did not belong in the current earnings statement and, accordingly, about the time of the fall of the market, they began to pass these items, principally losses, through the surplus account. Some companies consider profits on the sale of portfolio securities to be in the nature of capital and reserve them for the exclusive purpose of taking care of losses on similar transactions. Some have been consistent in always carrying such items through the profit and loss statement and others have been consistent in always carrying them through surplus. Reputable accountants have

supported all three of these methods. There seems to be no generally accepted practice in this respect.

The examples cited are only a few of the many that confront us in registration statements filed with the Commission.

Mention might be made of the varieties of ways followed in the treatment of (1) Income tax provisions for periods of less than a taxable year; (2) Surtaxes on undistributed profits; (3) Processing taxes; (4) Unassumed mortgages on property purchased subject to the mortgage; (5) Dividends on treasury stock; (6) Depreciation or retirement provision; (7) Long term debt falling due within one year; and a host of others.

In each of the examples mentioned some accountant has supported each conflicting viewpoint and has averred in his certificate that the statements reflected the application of accepted accounting principles.

This discussion has been mainly devoted to the recital of the variations in accounting practices followed by members of the profession because I saw no better way in which to bring home to you the extensiveness of the need for greater uniformity as we see it in our day-to-day work. What the future policy of the Commission will have to be I am not prepared to say but we are reluctant to undertake the prescription of principles to be followed except as a last resort. It is hoped the profession will itself develop greater consistency in the many places where uniformity appears essential to avoid confusion in the presentation of financial data and you may be assured the Commission stands ready, in whatever way it can, to assist the profession in accomplishing this purpose.

Some Problems of Administration of the State Income and Unincorporated Business Tax

By Roy H. Palmer

IT was with distinct pleasure that I accepted the invitation extended to me by your Committee on State Taxation to speak to you today on the subject of problems of administration of the New York State Income Tax Bureau.

I have the greatest of respect for The New York State Society of Certified Public Accountants both as a body and as individuals. It is my pleasure, as well as my duty, to record that which is my honest belief, that your organization has been and is now one of the greatest influences for good in the securing of wise legislation and in the honest and fair administration of income tax laws both in the Nation and in the State. Furthermore, I must acknowledge to you the assistance which has been rendered by the certified public accountants in properly advising taxpayers in the preparation of honest and intelligent returns.

I have often wished that I was a skillful accountant, a certified public accountant in fact, one who could meet you on your own ground; but, I am only a lawyer and a tax administrator. It has been my own experience that while the principles of law and accounting frequently meet on a common ground, the method of approach is so different that often the one fails to understand the language of the other. Both seek the same end but speak in different tongues.

In attempting to speak to you upon problems of administration of the Income Tax Bureau I have the distinct feeling that much of what I may say will be very trite and uninteresting. You, who are in the active practice of your profession, are so accustomed to dealing with the Bureau at Albany, and with our local offices, that it seems reasonable to assume that you are very familiar with the manner in which we operate and with most of our problems.

It has been my fortune to have been in executive positions in the State Income Tax Bureau since its organization in 1919 and I have seen it grow and have had a part in trying to solve many of its problems. A brief review of its work may possibly be of some interest and lead me to the discussion of the present problems it faces. As you know, the Income Tax Law was originally enacted to provide revenues to take the place of those derived from the old Excise Law and to provide funds not only for the State but for the localities. At that time it was assumed that the law would be more or less temporary. However, because of the growing demand for the extension of State functions and the expansion of social service work, and the resulting need for additional revenues to carry on such activities, this tax, instead of being temporary, has

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Presented at the November, 1936 meetings on taxation of The New York State Society of Certified Public Accountants.

become one of the largest revenue producers of all the State Tax Laws and a most important factor in the present tax system.

It is interesting to note the great variations in the number of returns filed and the total taxes collected during the past seventeen years resulting from changes in business conditions and amendments to the law itself. In the first year of collection with low personal exemptions of $1,000 for single persons and $2,000 for married persons about 1,000,000 returns were filed and with the low rates of 1%, 2% and 3%, a total of about $32,000,000 was collected. As the prosperity of the country advanced over the period of years through 1929 the revenues from this tax rapidly increased, and with personal exemptions increased to $2,500 and $4,000 respectively, the rates remaining the same, the total collection of tax for the calendar year 1929 was approximately $81,000,000, which was paid by about 400,000 taxpayers. Subsequent to the break in 1929 and the depression which followed, and with personal exemptions decreased to $1,000 and $2,500 respectively, and with rates increased to 2%, 4% and 6%, the total of collections was reduced to approximately $24,000,000 in 1933. However, with the partial recovery from the depression the number of returns has again increased, so that in 1936 based upon income for 1935 almost 600,000 individuals paid income taxes, and with the new graduated rates running from 2% to 7%, the latter being applied to all net income in excess of $9,000, and with the addition of the Emergency Tax, the total revenues collected were about $91,000,000 of which the State's share was something over $75,000,000.

These reductions and increases in numbers of taxpayers and in amounts collected created as they went along large problems of administration, since in the first instance the reduction of work required reduction in personnel to administer the law, and then again, the subsequent increase in the number of taxpayers and amounts of collections have required the personnel to be rebuilt to handle the heavier load. In 1926, in order to take up a part of the slack in the work caused by the increase of personnel exemptions, the administration of the Bank Tax under Articles 9-B and 9-C was entrusted to the Income Tax Bureau, thereby adding to it an important phase of the administration of the tax laws. Moreover, the enactment of the 1% Emergency Tax on income computed without the inclusion of capital gains or the exclusion of capital losses, and the recent enactment of the Unincorporated Business Tax Law (Article 16-A), have greatly added to the work which was originally assigned to the Personal Income Tax Bureau. Thus, during the period of seventeen years from the task of administering a relatively simple law, with low rates of tax and modest collections, the Personal Income Tax Bureau has grown in importance to the point where it is now charged with the administration not only of a somewhat complex law with very large collections of tax, but also with the administration of the Bank Tax Laws and the Unincorporated Business Tax Law.

In the main the organization of the Bureau has remained the same as it was originally planned by that master organizer and tax authority, Honorable

Mark Graves, and by your own Isidor Sack, and I feel that it speaks well for their ability to organize and their foresight that so few changes in method have been found necessary over these years.

It is not my purpose to tire you with a description of the organization, and of its mechanical workings, which are not particularly important to you and many of which are the usual mechanics of a business office. I will try rather to discuss some phases of the work in which difficulties exist.

As you no doubt know, the statute requires that every return received shall be audited. Including no-tax paid returns, fiduciary returns and partnership returns the Bureau in 1936 has received a total of at least 900,000 returns. This count does not take into consideration about 500,000 information returns on Forms 105, which are filed by employers and other disbursers of income in amounts in excess of the personal exemptions.

Question has sometimes been raised as to whether or not it is profitable and necessary to audit the smaller returns, that is those of taxpayers having compensation for personal services only in amounts which slightly exceed the personal exemptions. The answer is Yes. Our statistics indicate a considerable collection of additional tax through the examination and checking of these returns in which errors of amounts of income reported and improper claims for personal exemption frequently occur. Moreover, the psychological effect of auditing these returns is of greatest importance since failure to audit them would soon become a matter of common information, which would result in much evasion and the filing of incorrect returns.

It has been the constant purpose of the Bureau to audit the returns of one year so far as possible before the returns of another year were filed. Ordinarily this has been fully accomplished, the only exception being in the cases of those returns requiring correspondence with taxpayers, which delays the closing of the audit, and those returns which are recommended for a field examination, for which additional time is required.

Experience has indicated that the cost of auditing returns at the desk is much lower than the cost of auditing returns in the field, since by the latter method each audit consumes more time per man and frequently expense of travel and maintenance must be added. It thus results that the major part of the work is centralized in the Albany office and only those returns are audited in the field which appear to demand such treatment. A force of auditors is employed at the Albany office solely for examining returns at the desk and for making of such assessments and refunds as are clearly indicated to be due. The auditors assigned to the several district offices on the other hand are almost solely occupied in verifying the returns through the aid of the taxpayers' books. It may be of interest to note some of the results of the audit of these income tax returns over the period of years.

In the year 1921, for example, as a result of desk audit of returns for 1920, assessments of additional tax of approximately $1,400,000 were issued. In the following years, the revenues from this source varied from year to

year, but between 1921 and 1935 the average annual assessments of tax as a result of desk audit amounted to about $2,000,000, while in the year 1935, which was not a representative year because of the continuing effects of the depression, 900,000 returns were audited at the desk for a total return of $1,800,000.

Through the district offices the audit of returns in the field has produced additional taxes assessed of running from about $300,000 in 1922 up to $3,600,000 in 1932. In the year 1935 the aggregate was $1,500,000.

These figures do not include the results of investigation in the field for delinquent taxpayers, in which the Bureau has been extremely active, and collections from which have been most substantial. It is thus seen that our aggregate of additional taxes assessed through the work of audit has averaged from $3,000,000 to $4,000,000 per year. It must be borne in mind that these amounts are moneys which would not have otherwise been recovered for the State. Such amounts are greatly in excess of the cost of operation of the entire Income Tax Bureau in any year and in some years have covered the entire personal service compensation of all the employees of the entire Tax Department.

You may also be interested in the cost of collection of the tax. While this cost can only be approximated by reason of the overlapping of the functions of several of the Bureaus, resulting in a necessary approximation of the division of expense, it is estimated that the cost of collection in years of low returns has not exceeded two and one-half cents on every dollar collected, while in the years of the highest returns the cost of collection was as low as seven-tenths of one per cent.

One of the greatest problems of handling this volume of work and endeavoring to handle it properly is the difficulty of keeping a corps of trained people for this purpose. Practically every position in the Bureau is under Civil Service and positions are filled either by open competitive examination or by promotion examinations. This is no doubt a fortunate circumstance. While the Civil Service has its faults and it is not possible always to get the grade of employees that one might ask, nevertheless, the fact that the positions are not open to manipulation and that the service has continuity results favorably in handling the work. However, in a bureau of this type, where some technical training and experience is required, it is sometimes difficult to retain a force when it has once been trained, by reason of limitation of budgetary provisions, whereby it is impossible to adjust salaries to meet competition with outside personal service compensation. For example, when the Bureau was first organized, the entrance salary of the position of an auditor in the lower grades was fixed at $1,440 per annum, which was perhaps a fair and reasonable compensation in 1919. Subsequently, and prior to 1930, as prosperity increased, salaries and wages in the outside world increased rapidly in almost all lines of endeavor. As a result, many well trained auditors left the State service to enter private employment, and as no provision was made to increase salaries in proportion

to the increases in other fields, it became increasingly difficult to fill vacancies from open competitive examinations since the compensation did not attract those who were adequately trained and eligible. On the other hand, however, after the depression started in 1930, these salaries remaining the same, the audit positions became more attractive and Civil Service examinations were over-crowded with applicants for the positions at $1,440 per year. Among those who tried and qualified were lawyers and certified public accountants and men of very wide experience and training. As a result, it has recently been possible to fill the positions in the Bureau in the lower salary grades with men of very high calibre and ability, men capable of maintaining the personnel of the Bureau at a very high degree of efficiency. The difficulty is, however, that many of these individuals have taken these positions in desperation for the simple reason that for the time being they were unable to find anything better to do. Many of them, required to come to Albany to live, have found themselves discontented and constantly seek other employment. The result is that the coming of good times will result in the employment in other fields of many, whom the State has trained, and who might well become of great value to the Department, if State salaries could rise with competitive salaries on the outside.

Another problem which the Bureau has been obliged to face during the present year is that of additional work in the field. Higher rates of tax naturally make for increased tax resistance and create need for the examination of additional returns in the field in order to check the natural tendency to reduce taxes as far as possible. Moreover, the reduction in personal exemptions within the past two years together with the gradual uprise in business conditions has greatly increased the number of potential taxpayers and greater efforts must be made to seek out delinquents. The Bureau is meeting this need with a gradual expansion of its efforts all along the line with results that have been most satisfactory. It is most interesting to note that each man employed in the field work in the Bureau produces in additional tax at least ten times the amount of his annual salary, and this without consideration of the far reaching effects of this work in subsequent years or of the number of taxpayers who are thus deterred from evasion or skillful avoidance of tax.

One of the most difficult burdens that has been imposed upon the Bureau in its history was the provision for installment payments. I do not argue against the wisdom of this provision or the justice of permitting taxpayers to pay these taxes, which are becoming heavier year by year, in smaller payments. Nevertheless, it involves a tremendous task which costs the State a considerable amount of money without any added return for the payment of the expense. In the collection of 1935 taxes in 1936 approximately 120,000 persons or about 20% of the total paid taxes by the installment method. Since the original returns are due on April 15th and it is the policy of the Bureau to put installment notices for the June 15th installment in the mail as early as June 1st, it follows that only forty-five calendar days are available for recording the

600,000 original payments, computing the balance due, writing the bills and mailing them to taxpayers. Then again, when the two installments are due on June 15th and October 15th respectively, 120,000 payments must be received, listed, checked and posted to the accounts. This can only be done by means of expensive bookkeeping machines and a large force of clerical help.

For your information let me say that our system differs materially from that of the Federal in handling returns. All of the State returns are filed alphabetically under the Library Bureau code. The returns for a taxpayer for all years are kept in a single folder so that reference may be had to the taxpayer's entire record without searching in several files for the returns of the different years. The record of installments is made upon the installment bill itself and all postings are made on the copies retained in our files. Upon the payment of the final installment the complete record is then transferred to the taxpayer's folder to be associated with his returns and other correspondence.

The installment method of paying taxes would not have been so difficult to handle except that the enactment of the 1% Emergency Tax, together with a Minimum Normal Tax, and the Unincorporated Business Tax, all payable on April 15th, make a most difficult problem of segregation of collections. Each of these special taxes being retained wholly by the State must be kept separate and distinct from the Normal Tax which is divided with the localities. To add to this difficulty, when the rates were recently increased the statute provided that the localities should receive as their share of the taxes collected an amount which equalled the amount of taxes which they would have received had the rates remained at 1%, 2% and 3% as they were originally. This means that the tax on every return received must be recomputed before the payment is listed, in order that the tax as it would have been at the basic rates of 1%, 2% and 3% may be ascertained, and one-half thereof segregated for the localities.

In presenting to you these larger problems which are mostly internal, I do not know that you can do anything in particular to assist us other than to advise your clients of some of our difficulties and to be patient with us in some of these matters.

There are, however, several small details that occur to me in connection with the matters in which accountants are dealing with us day by day and in which they might be of considerable assistance.

For instance, you have no doubt noted that the letters coming from the Audit Division in Albany ask for a reply in ten days. This is not a direction but a request which we decided upon several years ago when we found that the taxpayers neglected to reply to our communications, or sometimes delayed reply for as long as two or three months. A prompt reply assists in the orderly disposition of cases. Unfortunately, it is not always possible for us to be as prompt in giving attention to your replies as we would like, on account of peak loads which intervene. In such cases accountants will frequently follow

up these letters asking why they do not receive replies, and although we are anxious to give a prompt answer, the second letter from the accountant only serves to cause confusion and possible further delay.

Then again there are those accountants who ask that special attention be given to their cases as a whole or to some specific case which they are handling. So many of these requests are received that it is impossible ordinarily to comply and most frequently there is no good reason why one taxpayer should have preference. I can only assure you that each one will get attention just as quickly as it is possible to give it and I ask you to give consideration to the fact that yours is only one of a million cases before the Bureau.

Immediately prior to April 15th each year we receive literally hundreds of applications for extensions of time. We have tried not to be illiberal in granting these requests but a great difficulty lies in the fact that nine-tenths of these are received within the last three days of the collection period and some come by telegraph message on April 15th. Naturally, it takes several days after that time even to type the extensions and mail them. Nevertheless, accountants, who have not been particularly anxious over the situation up until April 15th, begin to bombard us with telegrams and letters asking why extension has not been granted. I respectfully suggest that you make such applications at as early a date as possible in order to avoid this congestion. May I also suggest to you that it is not a particularly good excuse on April 15th or even on April 13th that a taxpayer has gone out of town, or that the accountant has not had time to make up the returns.

Another topic, which is worthy of some consideration, is the distribution of blanks. Necessarily the waste is tremendous, and the desire for economy has required the Bureau to consider the question of distribution from all its angles. Many accountants and banks desire the forms for returns shortly after January 1st even though the forms are not to be filed until April 15th. In mailing blanks to every taxpayer who has filed in the previous year addressograph plates are used to imprint the name and address and Library Bureau name code on each blank. It is a distinct advantage to the Bureau if those particular blanks can be returned to us as the original report of the taxpayer, since the imprint of the addressograph plate on the return makes it easily identifiable in the files as the return of a taxpayer who filed in a previous year and for whom a folder already exists. The Bureau has found by experience that if it mails these blanks early in January, a great majority of taxpayers misplace them or lose them entirely and then ask for additional blanks. Thus, not only is the purpose of imprinting the name on the return mailed to the taxpayer defeated, but a great waste is involved. On the other hand, if the blanks are mailed late, taxpayers become uneasy and, thinking that they have been overlooked, apply at our offices for other blanks. Experience has shown us that the purposes of all seem to be served best by mailing the blanks to taxpayers on or about the 15th of February in each year. Even then the taxpayer has two months before the return is required to be filed. The Association

of Accountants might cooperate greatly with the Bureau by not requesting a large supply of forms until notice is given that the blanks have been placed in the hands of the taxpayers through the mails, and then by using so far as possible the blank provided by the Department in each case.

In respect of those returns which require no payment of tax such as fiduciary and partnership returns (not involving Unincorporated Business Tax), we have provided the blanks for distribution on or about January 1st, since the earlier they are filed the more satisfactory it is to the Bureau, and there seems to be no good reason why they should ordinarily be held in the hands of the taxpayers until April 15th. You may also assist us greatly by filing partnership and fiduciary returns as soon as they are prepared.

May I comment too upon the apparent waste in forms on the part of some accountants. Requests will come to us early in January from accountants for 500 to 1,000 of each of the forms available. We are well aware that many of these orders are not based upon needs of the office of the accountant. For instance, an accountant ordering 500 personal income tax returns will also order 500 partnership returns and 500 fiduciary returns without any apparent thought at the disproportion of the latter two items to the first. I repeat that the waste of forms is tremendous and yet the Department does not feel justified in being niggardly in their distribution to the point of discouraging filing. I, therefore, merely suggest to you moderation in your requests for forms, realizing fully that in the making up of these returns you are assisting us and we wish to cooperate with you.

The Bureau has been in the habit of granting both formal and informal hearings on contested matters at the New York office. This has been done for the convenience of taxpayers and attorneys in order to save them the time and expense of going to Albany, which is still the capitol of the State and the seat of Government. Some accountants and attorneys seem to feel that they are at perfect liberty to cancel hearings whenever they see fit, by reason of other engagements or because of the absence of the taxpayer from town, or some other specious reason. The cancellation of a hearing means a wasted period for the hearing officer and we are becoming more and more of the opinion that in such cases the taxpayer must be informed that the postponement of a hearing will mean the removal of the case to the Albany office and that any hearing subsequently appointed must be had at that place.

Also, while on the subject of hearings, may I urge upon the accountants the proper preparation of the case before coming in for argument. Some accountants apparently have the thought that because many such hearings are informal they can come poorly prepared, without the necessary facts to establish their client's case and without presenting any further evidence than a bare statement of facts by the accountant himself. This is not acceptable. In every case, even of informal hearing, the accountant should prepare himself with proper affidavits, if he does not produce the taxpayer himself, and be prepared to prove all the facts upon which he bases his client's case.

One other matter in which accountants could well assist the Department is in the preparation of returns of information at the source on Forms 105 and 106. As you know, these returns are now due on February 15th each year. There are in the State at least 200,000 corporations in addition to all of the partnerships and individuals who are in business, employing individuals at compensation in excess of the personal exemptions. Notwithstandng constant publicity and the canvasses which have been made, we are of the opinion that very many employers in the State neglect this important detail. Many do not seem to understand that there is such a provision in the law or if they do understand it, they think it unimportant.

I need not tell you what an important function these returns of information play in the seeking of delinquent returns. They are the only means which we ordinarily have of checking salaries of individuals who are employed in the State. During the past year the Bureau has mailed out thousands of letters to individuals who had not filed returns with respect to whom information had been received in this manner and as a result several thousand returns were filed and taxes paid in substantial amounts by individuals who otherwise would have escaped taxation. It will be of material value to the State if the certified public accountants would thoroughly impress upon their clients and others with whom they have dealings the necessity of filing these returns.

I have not touched on the difficulties and problems of the Unincorporated Business Tax which we are administering for its first year. Naturally, many questions of law have arisen, some of which have not yet been solved. Very few administrative difficulties have been found, however, no doubt by reason of the fact that the law is so closely tied up with Article 16, that its application is much more easy than it otherwise would have been. Probably the one greatest difficulty has been to determine which of the professions are subject to the tax and which are not. So many border line cases exist where capital is or is not a material income producing factor, and where eighty per cent or more of the income is or is not due to the personal services of the proprietor that it is most difficult to separate the "sheep" from the "goats". Possibly the only remedy that might ever cure this situation would be to include all professions in the definition of what is an unincorporated business and subject them all to the tax.

In the time during which I have spoken to you I have endeavored to give you a brief outline of the work of the Bureau and of its problems. I do not know that I have given you anything new or of value. It has been our endeavor to administer the Personal Income Tax Law fairly and justly, with interpretations and rulings as liberal as could reasonably be made and with particular attempt at uniformity toward all taxpayers. Whether or not we have succeeded is not for us to say but for you and the taxpayers with whom we deal. Be assured that if you have any suggestions for betterment of the service, if your experiences show you that we are making any mistakes which should be corrected, we are always most glad to have your suggestions and we will value them in the future as we have valued them in the past.

Recent Decisions Affecting New York State Taxes

By Benjamin Harrow, C. P. A.

BY virtue of their sovereignty, no matter how limited in relation to the sovereignty of the Federal Government, States do have the power to tax. The growth of business activity, particularly where it is carried on in the corporate form; the ease with which persons and property, especially intangible personal property, move about across state lines, have brought about important changes in the concept of the relationship between persons and property on the one hand, and the state on the other. These changes have affected vitally the power of the state to tax persons or property, the general tendency being in the direction of a limitation of the power of the state to tax. Most of the recent cases, let us say those decided within the past twelve months, are concerned with the question of jurisdiction.

We are familiar with the principle that a state may tax persons or property within its jurisdiction. Except for a poll tax, the tax on persons must be measured by the property of that person with the result that innumerable situations may be found where the same property might technically be taxed more than once, i.e., once because the property is within the jurisdiction of a state, and again because the person who owns the property may be within the jurisdiction of a second state. The recent development of principles of taxation has been away from double taxation and this has been accomplished in part by restricting the jurisdiction of states to tax. The decisions discussed hereafter may show how this has been brought about, either by the application of constitutional limitations, redefined in the light of modern business activity, or by reading different meanings into such maxims as mobilia sequuntur personam (movables follow the person), or a more enlightened definition of situs.

Take the case of *People Ex Rel Cohen v. Graves.*[1] This case reversed a decision of the Appellate Division[2] and held that income from rents on real property located in New Jersey, as well as interest on mortgages on similar property, is taxable when received by a resident of New York. Three judges dissented. The Appellate Division had been unanimous in its opinion that such income could not be taxed by the State of New York, stating that the identical question had been decided in matter of *Pearson v. Lynch et al.*[3] Chapter 933, Laws of 1935, thereafter amended Section 359 of the Tax Law by specifically including in gross income, income from real property *wherever located,*

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① 271 N. Y. 353 Decided July 8, 1936.

② 246 App. Div. 335 Decided March 5, 1936.

③ 237 A.D. 763 (1933) Affirmed without opinion in 263 N.Y. 533 (1933); writ of certiorari dismissed as improvidently granted 293 U.S. 52 (1934).

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but the Appellate Division held that *Pearson v. Lynch*④ was decided solely on the ground that under the Fourteenth Amendment it was not within the power of the state to tax a resident on account of income from rents received from land situated beyond its borders. The Appellate Division further maintained that the Supreme Court in *Senior v. Braden et al.*,⑤ reapplies the law as it was stated in the *Pearson* case. In *Senior v. Braden,* the Court held that the land trust certificates were interests in land and that the State of Ohio could not tax these certificates, if the land was situated outside of Ohio. The Ohio taxing statutes read, "All investments and other intangible property of persons residing within the state should be subject to taxation". In *Pollock v. Farmers Loan and Trust Company*,⑥ the case that declared the income tax law of 1894 unconstitutional, thus necessitating the Sixteenth Amendment to the Constitution, the Court held that a tax upon the income from land was tantamount to a tax upon the land and that, therefore, such a tax was a direct tax and unconstitutional. The Appellate Division in the *Cohen* case and the dissenting judges in the Court of Appeals just refused to laugh off the *Pollock* case, even though Judge Crane in the majority opinion bravely attempts a reconciliation of the *Cohen* case with the *Pollock* case by saying that "What may be a direct tax under the Federal Constitution, may be income (as it really is) for other purposes".

If the Supreme Court of the United States should reverse the Court of Appeals on the ground that only the state of the situs of land may tax the income from that land, following the *Pollock* case and *Senior v. Braden,* a serious limitation is set, as a practical matter, on the power of a state to tax persons domiciled or resident within a state, where the tax must inevitably be measured by that person's property.

Mention was made a moment ago of the maxim, mobilia sequuntur personam. The case of *Frick v. Pennsylvania*⑦ held that this maxim could no longer apply to tangible personalty, limiting the meaning, therefore, to intangibles. The *Frick* case involved an inheritance tax and held that only the state of the situs of tangible personalty could tax the transfer at death of such property. The state of the domicile of the decedent had no power, the court said, over such tangible personalty and, therefore, had no jurisdiction to tax its transfer at death.

Later cases⑧ have restricted death taxes on the transfer of intangible personalty to the state of the domicile of the owner. The situation, with

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④ See Note 3, supra.
⑤ 295 U.S. 422.
⑥ 157 U.S. 429.
⑦ 268 U.S. 473 (1925).
⑧ Farmers Loan & Trust Co. Executor v. Minnesota 280 U.S. 204 (1930).
Baldwin v. Missouri 281 U.S. 586 (1930).
First National Bank of Boston v. Maine 284 U.S. 312 (1932).

respect to a death tax on the transfer of intangible personalty that has acquired a business situs or commercial domicile, as Justice Hughes described it in *Wheeling Steel Corporation v. Fox*[9] has not yet come before the Supreme Court of the United States, but the State of New York has had before it under its income tax law, the question of taxing the profit on the sale by a non-resident of intangible property that has acquired a business situs in New York. The case is *People Ex Rel C. Handasyde Whitney v. Graves.*[10] The court held that a non-resident was taxable on a profit from the sale of an interest in a membership on the New York Stock Exchange, although neither the non-resident, nor his partners, nor his firm ever had a place of business in New York. The Court of Appeals found that the sale was effected through the Secretary of the New York Stock Exchange in New York and that transfer was made by giving the power of attorney to a New York firm. The New York Stock Exchange is an unincorporated voluntary association and holds the beneficial ownership of the entire capital stock of a New York corporation, which in turn owns the building in which the business of the Exchange is transacted and which building is situated in New York.

Presumable, the court has determined a business situs in New York for this transaction, or it may be that the court felt that an interest in a membership in the Stock Exchange is really an interest in land situated in New York. In *Citizens National Bank v. Durr,*[11] the Supreme Court has held such membership to be a chose in action and taxable by the state of the domicile of the owner. The State of Massachusetts, under its income tax law, could presumably also tax the profit on this sale, Massachusetts being the domiciliary state of the taxpayer. In *Pearson v. Lynch,*[12] the court held that the profit on the sale of real estate situated outside of New York could be taxed by New York. The *Whitney* case is now before the Supreme Court pending the granting or denial of a writ of certiorari.

Basic principles of taxation are usually sound. Taxpayers become restive under increasing burdens of taxation only when basic principles are disturbed by extraneous factors that creep into tax laws. For example, the principal of equality in taxation has been needlessly disturbed by the factor of exemptions. The exemption of federal and state instrumentalities from taxation has today become a serious problem. The justification for exempting state instrumentalities is founded, it seems to me, on untenable grounds, but it is not my purpose to enlarge on this problem this afternoon. The exemption of federal instrumentalities from taxation by states, while it has a firmer basis, nevertheless, should be restricted to conform to principles of equality in taxation. In attempting to limit such exemptions, we have the recent case of

[9] 56 S. Ct. 773 (1936).

[10] 283 N.Y. Sup. 219 (1935), affirmed 271 N.Y. Mem. 90, May 19, 1936.

[11] 257 U.S. 99.

[12] See Note 3, supra.

People Ex Rel Rogers v. Graves.(13) This case involved the power of the state to tax the salary of an employee of the Panama Railroad Company. The entire capital stock of the company is owned by the United States. If the corporation is to be considered an instrumentality of the United States, it is exempt from state taxation, and the salary of the employee is similarly exempt. Contending that the company is not engaged in the conduct of an essential governmental function, the Appellate Division held that the salary was taxable. This is the argument employed in a long line of cases involving the taxation of state instrumentalities under the Federal Income Tax Law.(13a) Whether the federal and state sovereignties are to be considered as equal and thus entitled to reciprocal exemptions will be determined in the final decision to be given by the Supreme Court, where the case is now pending.

Not so many years ago, when judges were more liberal in permitting exemptions, it was held that royalties on patents and copyrights were federal instrumentalities and so exempt from taxation by states.(14) A few years later, the Supreme Court reversed itself and properly overruled this decision in *Fox Film Corporation v. Doyal, et al.*(15) In *People Ex Rel Rice v. Graves, et al.,*(16) the Court recently held that New York may impose an income tax upon income received from royalties not taxed during the years when it followed *Long v. Rockwood,* upon the overruling of this case by *Fox Film Corporation v. Doyal, et al.* Furthermore, the Court held that a decision overruling a prior decision is retrospective in operations, the interpretation of the law, as declared in the latter decision, superseding the prior one as of the date of the prior decision. Incidentally, the Wisconsin Supreme Court recently arrived at a similar decision.(17)

To levy and assess a tax under a tax law is comparatively simple. To enforce payment and collection may be a more difficult problem. The recent case of *Milwaukee County v. M. E. White Co.*(18) has made the latter problem somewhat less difficult. The case rests basically upon the legal proposition that a judgment obtained in one state will be given full faith and credit in other states. In this case an action was commenced in Illinois on a judgment obtained in Wisconsin against the defendant for income taxes. In the Supreme Court, the Appellee contended that a judgment for taxes constitutes an exception to the requirement of the Constitution of the United States that full faith and credit be given in each state to the public acts and judicial proceedings of every state, for the reason that one state will not enforce the penal laws of another state. The Supreme Court held that the obligation to

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(13) 245 App. Div. 452 (1935), affirmed 271 N.Y.—April 29, 1936.

(13a) Helvering v. Powers 293 U.S. 214.

(14) Long v. Rockwood 277 U.S. 142.

(15) 286 U.S. 123.

(16) 242 App. Div. 128, Affirmed 270 N.Y. 498, certiorari denied U.S. Sup.Ct. June 1, 1936.

(17) Raabs v. Wisconsin State Tax Commission 261 N.W. 404.

(18) 56 Sup. Ct. 229, December 9, 1935.

pay taxes is not penal. It is a statutory liability, quasi contractual in nature, enforceable as an action of debt. There were two dissents.

In 1934, *the New Jersey Court of Errors and Appeals in People of the State of New York v. Coe Manufacturing Co.*[19] had upheld the right of New York to collect on a judgment for New York State franchise taxes against a foreign corporation. Here, too, the Court held that the statute under which New York State recovered the judgment was not a penal statute. Several dissents were noted.

The trust device has found increasing favor, and rightly so, among taxpayers in their attempt to reduce the mounting burden of taxes. Nevertheless, courts have in a number of cases frustrated such efforts and in the process they have been compelled to redefine and limit legal concepts of ownership. It is quite startling, but true, that today a taxpayer may be subject to tax on property or the income from property that he does not own. Taxation, as courts keep repeating, is eminently a practical matter. The case of *Burnett v. Wells,*[20] wherein a taxpayer was taxed on the income of an irrevocable trust set up to pay premiums on policies of life insurance payable to members of the grantor's family and relatives was the forerunner of a line of Supreme Court decisions[21] extending this principle to other cases involving trusts for the benefit of the grantor. These cases hold that income from trusts created for the purpose of discharging a legal obligation of the settler is to be considered as the income of the settler. In ruling of the Department of Taxation and Finance, under date of October 22, 1936, the State Tax Commission holds that these decisions are applicable under the personal income tax provisions contained in Article 16 of the New York Tax Law. Examples of trusts within this ruling are those, the income from which is to be applied in payment of alimony to a divorced wife,[22] income to be used for the support and maintenance of infant children,[23] income to be applied in payment for debts.[24]

No discussion of recent tax decisions could omit the case of *Colgate v. Harvey.*[25] The full import of this decision has not yet been realized. More so than any other case, this decision sets a decided limitation on the part of a state to tax. The case involved a problem of classification and a concomitant problem of exemption. A Vermont Income Tax Law taxed dividends earned outside of Vermont while exempting dividends earned within the State of Vermont.

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[19] 112 N. J. L. 536.

[20] 289 U.S. 670.

[21] Douglas v. Wilcuts—296 U.S. 1.
Helvering v. Schweitzer—296 U.S. 551.
Helvering v. Stokes—296 U.S. 551.
Helvering v. Blumenthal—296 U.S. 552.

[22] See Note 21, supra.

[23] See Note 21, supra.

[24] See Note 21, supra.

[25] 296 U.S. 404—December 16, 1935.

For the reason that domiciled corporations paid a franchise tax of 2%, this classification as to dividends aimed to produce equality, the court said, and hence the exemption was held to be proper. The Vermont law also taxed interest from money loaned outside the State of Vermont and exempted interest from money loaned within the state where the rate of interest did not exceed 5%. This classification the court held to be invalid. In connection with the principle of classification, the court said that it must be reasonable and must rest upon some ground of difference having a fair relation to the object of the legislation, so that all persons similarly circumstanced shall be treated alike. The court pointed out that the law did not state that the money so loaned must be invested in property having a situs within the state and that, therefore, the classification was based upon the mere circumstance as to the place of making the loan.

The decision is startling in that it invokes the equal privileges and immunities clause. The court goes on to say that the right of a citizen of the United States to engage in business, or to make a lawful loan of money in any state other than that in which he resides is a privilege equally attributable to his national citizenship. Therefore, the discriminatory tax here imposed abridges the privilege of a citizen of the United States to loan his money and make contracts with respect thereto in any part of the United States.

In a vigorous dissent disapproving of the majority opinion, Justice Stone points out that this novel application of the privileges and immunities clause making the owning and receiving of income from investments without the state a privilege of federal citizenship would preclude all differences of taxation of the two classes of income. The clause would become an inexhaustible source of immunities imposing on the states the heavy burden of an exact equality of taxation, wherever transactions across state lines might be involved. It would follow, he said, that any taxation of this income is forbidden.

The distinction between income and a gift is the basis of a decision in the case of *Bert L. Jones v. Loughman et al.*[26] In this case an employee received $125,000.00 in appreciation of his efforts over a period of twenty-five years. There was no legal claim for this income, but there was a moral obligation on the part of the company and the stockholders to compensate him. The court held that the payment of this money in excess of his salary in consideration of past services constituted payment for past services and therefore was not a gift. This decision is in line with the Federal law as adjudicated in *Noel v. Parrott*[27] *and Schumacher v. U.S.*[28]

In the remaining moments, a few comments should be made on several cases involving the New York Franchise Tax.

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[26] 288 N.Y.S. 44 May 6, 1936.

[27] 15 Fed. 2d 669.

[28] 55 Fed. 2d 1007.

Section 209 of the Tax Law, Chapter 376 levies a franchise tax on corporations based on net income. Section 208 defines the term "corporations" to include an association and any business conducted by a trustee wherein interest or ownership is evidenced by certificate or other written instrument. In *City Bank Farmers Trust Co. v. Graves*[29] the court held that an investment fund known as the Farmers Loan and Trust Co. Investment Fund No. 1 was subject to a franchise tax on its net income. This case is reminiscent of the continuous controversy in the Federal Courts over the taxation of trusts as associations ranging from *Hecht v. Malley*[30] to *Morrissey v. Commissioner of Internal Revenue.*[31] The court held that the business of the trustee was conducted in a corporate or organized capacity and even though the certificate holders delegated the entire management without reserving the right of substitution of trustees or control of its actions, there was an "association" of the certificate holders, and they were operating in an organized capacity. The statute was held to be broad enough to subject this trust to the franchise tax. The test apparently is that the association resembles a corporation.

Mention should be made of the fact that the State Tax Commission has power to grant the release of real property upon which a franchise tax is a lien, upon payment to it of an adequate consideration. This was emphasized in an opinion of the Attorney-General.[32] Applications for such releases are made on Form 100 C.T.

One further case involves the question of priority of claims in Federal receiverships. In *Rudolf Spreckels v. Spreckels Sugar Corp., et al.,*[33] the court held that administration expenses and fees receive first priority; taxes during receivership should be paid prior to other tax claims. As to tax claims which accrued prior to receivership, the claim of the United States must be given a superior position, the time of filing liens being immaterial. If no steps have been taken to perfect a tax claim of the United States, it is subordinate to the lien of New York State Franchise Tax.

This discussion has been limited to the field of income and franchise taxation, the limitation of time preventing a proper treatment of other cases, particularly in the field of estate taxation.

To sum up, the recent cases show a tendency in two directions. The need for increased revenues on the part of the states reflects a tendency for courts to construe statutes strictly in favor of the state. The increasing burden of taxes has compelled taxpayers to appeal to the courts for a construction of taxing statutes that would limit the power of states to tax. It seems to me that the pendulum is swinging in the second direction today, so far as state taxes are concerned.

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[29] 272 N.Y. 1 July 8, 1936.
[30] 265 U. S. 144.
[31] 296 U.S. 344.
[32] 217 (1935).
[33] U.S. Dist. Ct. So. Dist. of N.Y. October 22, 1936.

The Certified Public Accountant's Responsibility to Third Parties for Financial Statements to Which He Certifies

By DAVID L. PODELL

IF I may amplify the question for discussion, let us assume that a certified accountant has been engaged by a client to make an audit of its books of account. At the time of the employment and the preparation of the financial statement, the accountant knows that the client intends to use that statement either with a banker or a credit man or some other third party to secure credit in reliance thereon. The accountant then makes his audit either personally or through a staff of juniors supervised by executives. He then prepares his report of the audit and vouches unqualifiedly for its correctness and accuracy and expresses further the unqualified opinion that the statement represents the true financial condition of his client.

Assume that this statement with this unqualified certificate is then submitted by the client to a banker or credit man or other persons and credit is secured thereon. Assume further that it subsequently develops that the statement is substantially false; that in truth and in fact the client or his employees or any one of them has juggled and manipulated the figures; that these false figures thus created have not been detected by the accountant to the resultant damage and injury of the banker, the credit man, or a third person.

I understand that others here will discuss the rights of the client if he is innocent. I am asked to consider the rights of these third persons.

Since our Court of Appeals has written in the Ultramares case, the off-hand answer of most people who are familiar with that decision would be that the banker and the credit man or third persons have little, if any, remedy in the law, and that they have none at all for negligence.

General public conception of the holding of the Ultramares decision is that the accountant is only liable to his own client and that he owes no duty to third persons who may rely on his certification to a financial statement. I am excluding for the moment any consideration of the securities enactments of recent years and the liabilities which those acts impose in the case of registered securities sold to the public.

If that be the general assumption as to the effect of the decision in the Ultramares case, it is high time that accountants were cautioned and plainly told that such a conclusion is utterly fallacious and that unless they clearly understand the holding of the Ultramares case, they are apt to come to grief and to incur obligations and liabilities that frequently run into substantial figures; that as a matter of safety for themselves as well as for the community that they are serving, they had better revise their ideas and get to a full realiza-

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tion of the hazards of their profession, and more especially, get to a clear understanding of the exact implications of the Ultramares case.

All that that case holds, and when I state it I am stating the extreme limits that it goes to, is this: that where there has been an honest blunder by an accountant, and he is sued by the banker or the credit man or some third person *for negligence,* there can be no recovery against the accountant. Bankers and credit men and third parties cannot sue the accountant for negligence. That does not mean that they are prohibited from suing him and securing recovery on other grounds than negligence, even if under certain circumstances the accountant's offense or omission is not inspired by any deliberate intention to deceive.

I shall have occasion to amplify this statement as I go along in my remarks. But, first, let me explain why our highest court holds that the banker who relies on a false statement, even when the accountant knew that the banker would issue credit on the strength of it, or the credit man or any other innocent third party, cannot sue the accountant for negligence.

The Ultramares case is the first of its kind in this State to answer that question definitely and settle the law on that subject. In reaching that conclusion, Judge Cardozo, who wrote for the Court, reviewed a number of borderline cases and ultimately decided that recovery for negligence as against the accountant should be confined to the *client alone* and should not be extended to third parties relying on the statement.

The simple reasoning of the opinion is that the duty on the part of the accountant to act with care and prudence, the duty not to be neglectful, is a duty that is inherent in the contract that he makes with his client. And since the banker and the credit man and third persons relying thereon have no privity of contract with the accountant, no such duty has been assumed by the accountant toward them and there is therefore no possible liability which would arise from his honest blunder, the result of neglect.

True, the Court said, there had been some cases where third persons had been allowed to recover for negligence under similar situations not involving accountants, but if they allowed recovery against an accountant by third persons for negligence, every time that an accountant engaged himself to his client for an audit and prepared such an audit, he would be assuming an *indeterminate* obligation to an *indeterminate* number of persons for an *indeterminate* amount of time, for a blunder inadvertently, or if you please, negligently, committed in the utmost good faith.

And so they held that such a case is quite different from the case where a seller of merchandise goes to a public weigher and gets a certificate showing that the weight of that merchandise aggregates a certain amount, and the buyer, a third person, receives that certificate and that certificate is false. There the risk is limited to either the seller or the purchaser, and there is not a liability to the whole world as there would be in the case of the accountant. Every man in the conduct of his business and in the conduct of his profession

has a right to limit his liability, and the Court held it would not be fair to assume that when an accountant is engaged by a specific client to do a specific job, that in making such an arrangement for that work, he not only assumes the risk of a suit for negligence by his client but by whomever in the whole world reads the statement and relies on it and issues credit.

The Court at the same time though, and this I cannot emphasize too strongly, declared that that same accountant owes a duty to act honestly and in the utmost good faith to the whole world or anyone in it that may rely on the statement which he certifies. And what is even more important, the Court very clearly held in that case that *gross neglect may be evidence of bad faith* and where there is bad faith or misrepresentation he has violated his duty to anyone and everyone in this wide world who may rely on it to his damage.

The high standards of the accountancy profession in our community are best evidenced by the fact that considering the multitude of transactions in which they have engaged, and the innumerable audits that they have had to make, suits against them either for negligence or for fraud have been insignificantly few. And there need be no concern that any reputable accountant in this community will deliberately, or that his employees will deliberately, shut their eyes to inaccuracies or falsities in bad faith. But under the decision in the Ultramares cases, an accountant can act in the utmost good faith and still be liable to third persons in a cause of action for misrepresentation. Call it constructive fraud or gross negligence or by any other name, there may still be a liability to third persons in such a case.

You know that our Courts have held that where a man makes a definite statement, believing it to be true, when as a matter of fact he has made but a flimsy investigation and does not know whether that statement is actually true, he is liable for a misrepresentation, and it is that principle which gives rise to suits by third persons who rely on the statement to their damage.

Let us take the very facts of the Ultramares case by way of illustration. A large accountants' firm sends its juniors into the establishment of the client under the guidance of an executive to make the audit. They certify unqualifiedly two things: first, that the financial statement in all respects corresponds to the books of account, or rather reflects what is contained in the books of account; and secondly, that in their opinion it represents a true statement of their financial condition. The statement shows a net worth of assets over liabilities in excess of one million dollars. The truth of the matter is that at the time of the audit the client was insolvent. One item of accounts receivable aggregating $700,000 was entirely fictitious, and while it appeared in the accounts receivable ledger, it had no supporting entries in any of the books of original entry. A number of the same accounts receivable had been pledged with two or more banks. An inventory of $350,000 had been padded to the extent of almost $300,000. Naturally, both the client and those conniving with him in the manipulation had exercised their skill and their ingenuity and the extremest caution to prevent the detection of these items by the accountant. The account-

ant had, however, certified unqualifiedly that his financial statement reflected the true condition of the books of account, and that in his opinion it represented the true financial condition of the client. These are definite unqualified representations, and in practical effect, the question that was presented in the suit for misrepresentation against the accountants by the third person was whether they made a sufficiently adequate examination so that they could definitely make both those certifications.

I say in practical effect, and by that I mean that the Court in the Ultramares case did attempt to draw a line of distinction between ordinary lack of prudence and care, the ordinary case of negligence on the one hand, and a case of gross neglect on the other. That distinction at best involves the question of degree of neglect and there is no sharp dividing line. There is no yardstick by which the scope of ordinary negligence may be measured to distinguish it from gross negligence. It is fair to say that what might be considered ordinary neglect by one man might be regarded as gross neglect by another. The law solves its difficulties by throwing the whole question to a jury and letting them puzzle it out.

Should a jury come to the conclusion, in such a case, that the accountants did not make such an adequate examination and that they really could not know and did not know whether the statement corresponds with the books, or should a jury find that they had not made a sufficiently adequate examination to know whether the financial statement was true when they certified definitely in their opinion that it was true, then the verdict could be for the plaintiff third person, regardless of the good faith of the accountant.

In short, there can be recovery by a third person in an action for fraud even though he is unable to prove and does not prove that the accountant intended to deceive or practiced any form of deceit. The principle is old in actions for misrepresentation. Long ago our courts held that when a man sells a piece of land and warrants that it is free from rock underneath the surface, when he has never drilled and never investigated sufficiently to know whether there is rock or not, that he is liable for misrepresentation regardless of his own honest beliefs or his good intentions.

Our law goes to the point that no one has a right to make definite statements and give definite assurances when he is uncertain in his own mind as to what the real facts are. It follows, therefore, that in almost every one of these cases the pivotal question is: Was there such an examination as would justify a definite certification that the financial statement truly reflects the condition of the books, or to warrant a definite opinion that the financial condition reflected in the statement is true?

Note the language of our Court of Appeals in the Ultramares case:

> "The defendants certified as a fact, true to their own knowledge, that the balance sheet was in accordance with the books of account. If their statement was false, they are not to be exonerated because they believed it to be true. We think the triers of the facts might hold it to be false.

> "Correspondence between the balance sheet and the books imports something more, or so the triers of the facts might say, than correspondence between the balance sheet and the general ledger, unsupported or even contradicted by every other record. The correspondence to be of any moment may not unreasonably be held to signify a correspondence between the statement and the books of original entry, the books taken as a whole. If that is what the certificate means, a jury could find that the correspondence did not exist and that the defendants signed the certificates without knowing it to exist and even without reasonable grounds for belief in its existence."

And when you come to the question of whether there was or was not adequate examination properly conducted, you are in the realm of uncertainty.

Here is a significant quotation from a brief in an important case which may be taken as expressive also of a lawyer's criticism:

> "The technical procedure to be followed in the auditing of accounts is far from being well settled. In the present stage of the profession's development, there is scarcely such a thing as standardized procedure. Current procedure is governed largely by individual opinion and judgment under the circumstances of each particular case. Consequently, there may be wide differences of opinion as to what constitutes proper procedure. By the same token, it is equally difficult to determine what constitutes negligence. There is little in the way of authoritative statement which serves as a basis of judgment on this point. Except as definite procedure has been established in certain scattering instances, as the result of study and research with respect to certain phases of auditing work, it is difficult for anyone to state what course would be followed in a given situation by the average man possessed of adequate skill and exercising due care. Too often the question of care and diligence hinges on an auditor's success or failure in detecting irregularities which have been ingeniously planned, executed and concealed. Consequently, the detection of such irregularities results, not from the exercise, by the auditor, of reasonable care and diligence, but from the use of hyper-skill and individual cleverness which surpass the shrewdness of the perpetrator."

Certainly the terminology of accountants should not be subject to the decision of twelve jurymen who have little, if any, knowledge of accountancy. In this connection I may quote from an article in November, 1932 Certified Public Accountant, in which the author states:

> "In making a fetish of the short unqualified certificate accountants have borrowed a great deal of trouble for themselves. As a consequence it is too often left for the jury to discover through the evidence just what it was the accountant did and what his agreement and the standards of his profession required him to do."

The author therein suggests that there should be a standardization of accounting and auditing technique and terminology with which I heartily agree.

You are at the hazard of a jury's determination, which no one can foretell until he sees the jury and even then cannot foretell with any certainty until he hears the verdict.

I certainly have no desire to add to the burdens of the accountant's profession. I have had impressed upon me through the years the many hazards of that profession. But it seems to me I would be doing an injustice to the accountants who are seeking a real grasp of the legal principles enunciated in the Ultramares case if I did not emphasize its lurking dangers to the accountant, if I supinely acquiesced in the general acceptance of the principle that the Ultramares case gives no right of recovery to third persons.

My own view is that third persons have greater rights, but for the lack of a right to sue for negligence, then even the client. In the case of the client, if the accountant can show that the client has himself been negligent, he has a defense to any suit for negligence and usually it is not difficult to show that the client has been himself neglectful.

If the client sues for fraud, it may well be that the client has himself been implicated in the fraud. He may be chargeable with the fraud of certain of his own employees as matter of defense. But since third persons cannot sue for negligence, there is no such thing as a defense of contributory negligence. Putting it in other words, contributory negligence is not a defense to a suit for misrepresentation. Of course, the third person must always show that he relied on the statement. He must always show that he has been damaged as a result of the particular false statement and in reliance thereon. But once he has shown that, and has shown a misrepresentation, to wit, a definite statement which is unwarranted by reason of an inadequate examination by the accountant or a grossly negligent examination by the accountant, he has made out a case.

I cannot say that I have any quarrel with the law as it stands. The recent years of suffering have driven home to merchants and professional men everywhere a greater sense of social responsibility, responsibility to the community that we are serving—not merely to our stockholders, not merely to our partners or the members of our corporation, and not alone to our own interests, but rather that broader implication which must take into account the needs of the entire community and all those who may be dependent on the service that we are rendering.

While it is just that our courts should limit liabilty for negligence to the client alone, I can see no injustice in requiring that the accountant should not make unqualified definite statements when as a matter of fact his examination does not warrant them, to the great injury of innocent third persons. Either limit your certification and standardize the technique so that all who read may know your limited examination, your qualifications of your certificates, or else be sure that your examination is sufficiently thorough and adequate to warrant the definite and ultimate certification.

That this is in accord with the spirit of the times and the trend of our law towards the ideal of social responsibility, is best evidenced by the incorporation in the Securities Act of 1933 of even a broader principle of liability against the accountant—in my judgment far too broad. In our Securities Act it is in

substance provided that even though a purchaser of securities has never read and never relied upon the certified public accountant's statement, if that statement has omitted a material fact, or if that statement is misleading, there is liability on the part of the accountant to the purchaser of those securities, as there is on the part of others who may have had a hand in the preparation of the statement.

And even though we may hold that such provisions are far too broad, we must admit that at least so far the Securities Act as a whole, with all of its provisions, however broad they may be, has worked out to the great benefit of the community. And not the least of those benefits has been the confidence which has been inspired in the securities market by those very provisions. Accountants have been made more cautious. Lawyers have been made more cautious. And I know that bankers and financiers have been more careful as a result of that Act.

Of course, the Ultramares case and any other cases in which our courts had written on the subject of the responsibility of a certified accountant to third persons prior to the Securities Act have no bearing whatever on the provisions of the Securities Act. Those provisions constitute a Federal law and are a law unto themselves. In the course of time I have no doubt its provisions will be construed and interpreted by our courts, and how far a provision of law which gives a right to a third person to sue upon an inaccurate statement when as a matter of fact he never relied on it, never read it, did not know of its existence, will work grievous injustice, remains to be seen. If it does, it can be remedied by amendment. If it does not work injustice, and has the tendency, on the other hand, of making everybody more cautious, including the accountants, at the same time that it inspires and retains confidence in our security issues, it ought to be allowed to remain.

To indicate the nature of the requirements under the Securities Acts let me refer to Rule 651 of the General Rules and Regulations promulgated in 1936 by the Securities Commission:

> "The certificate of the accountant or accountants shall be dated, shall be reasonably comprehensive as to the scope of the audit made, and shall state clearly the opinion of the accountant or accountants in respect of the financial statements of, and the accounting principles and procedures followed by, the person or persons whose statements are furnished. In certifying to the financial statements, independent public or independent certified public accountants may give due weight to an internal system of audit regularly maintained by means of auditors employed on the registrant's own staff. In such cases the independent accountants shall review the accounting procedures followed by the registrant and its subsidiaries and by appropriate measures shall satisfy themselves that such accounting procedures are in fact being followed. Nothing in this Rule shall be construed to imply authority for the omission of any procedure which independent public accountants would ordinarily employ in the course of a

regular annual audit. The certificate of the accountant or accountants shall be applicable to the matter in the registration statement proper to which a reference is required in the financial statements. Promulgated by General Rules and Regulations, January 21, 1936, effective March 15, 1936."

In conclusion, accountants have an advantage which lawyers have not. Accountants are open to secure adequate insurance against honest mistake. It seems to me it cannot be emphasized too strongly that the accountant should not allow himself to omit such qualifications and limitations to his certification as he deems necessary and commensurate with the audit he has made. He should let the world know that he made merely a limited audit as distinguished from a general detailed audit. He should let the world know what he has checked thoroughly and what he has not checked. He should be most cautious of making final definite unqualified certifications. In the large organizations of accountants the executive in charge of the audit must be a man of exceptional competence whose eagle eye will detect any laxity on the part of his subordinates. He certainly should not hesitate to point out incompetence among the client's employees. He should see to it that the client installs and pursues the proper system in his own establishment.

And finally, it seems to me he should labor incessantly to secure some measure of standardization in the profession, some common accord on procedure, technique, and terminology so that there would not be the constant bickering and dispute as to the meaning of technical phrases such as "balance sheet audit", "detailed audit", "general audit", "books of account", "accounts", etc.

Above all, at all times, especially in these times, it seems to me vital for the safety of the accountancy profession and of the community always to have in mind the rights of that multitude of unknown innocent persons who will place reliance and act on the strength of the statement to which the accountant certifies.

The Duty of the Certified Public Accountant to the Business Community as Distinguished from His Duty to His Client

By John L. Redmond

OF course, bookkeeping is a very ancient profession. They dig up cuneiform tablets in Babylon, and Ur, of the Chaldeas, and many of those ancient places, showing that business records were kept many many years ago. Cost accounting is also ancient, though not quite as ancient as bookkeeping, because we find in the Epistle of St. Paul, in which he said "Which of you intending to build a tower sitteth not down first and counteth the cost whether he have sufficient to finish it".

Now, merchants have no such sacred ancestry, or biblical ancestry, as have bookkeepers and cost accountants.

I remember reading in "Neitsche" (I suppose I should not read that kind of book, but anyway I did) a passage which struck me rather forcibly, and that was where he said, "Merchant and pirate were, for a long period, one and the same person". Well, we must not take him quite too seriously but I thought it would be of interest, anyway.

The accountant really developed from the bookkeeper. Originally, when we first started out in the accounting field as distinguished from the bookkeeping field, the accountant was compiling information for his client; that is, the proprietor wanted to know whether the cashier was peculating any funds, or he wanted to know if the bookkeeper was keeping his balances right, and then he also wanted to know whether their theory of bookkeeping was correct. Later on, the development from that was when the banker and the merchant required of the customer (the "client", we will call him, in this case) that he have a statement prepared by an independent party, and so it gradually became the practice to require each man in business—that is, a business of any size—to submit, once a year to his bank and to his larger suppliers, a financial statement of his condition as it existed, usually on the first day of the business year, or the first day of the calendar year. From that, the banker and the credit man, becoming a little wiser through sad experience, began to require the client also to submit profit and loss statements prepared by a qualified accountant, so that they might see not only the condition of the business but the circumstances which led up to that condition. Today we have gotten a step beyond that and it is becoming more and more the practice, particularly in the lines of business where the seasonal change is very violent, to require a continuous audit.

Presented at the December 14, 1936 meeting of The New York State Society of Certified Public Accountants.

I am not going into any details as to how an audit should be conducted, as I am merely a layman and should not say anything about that, but there is one thing I wish to stress and I will repeat it slowly because this is the whole point of what I have to say, and that is, that *any accountant engaged in a continuous audit who permits his client to get into such a condition that he has to compromise with creditors, is justifiably open to criticism and withdrawal of patronage.*

That is necessarily a strong statement. I know a lot of people will object to the fact that an accountant has no right to reveal the affairs of his client because of a confidential engagement which he has entered into with that client, but let us stop for a moment—there is no more sacred relationship than that of the doctor with his patient, and yet, when any contagious diseases are treated by that doctor, he is under obligation to report it to the Board of Health regardless of the fact that he still is in the confidential relationship of doctor and patient. And also, when someone comes to the doctor for treatment of a gunshot wound, he is bound to report it to the Police Department.

I do not mean to assert, that as soon as an accountant finds out that his client is in a bad way he should immediately run and publicize it and spread it broadcast; not by any means. I still say that his first duty is toward his client. He must urge upon the client, first, that he reorganize the business (if that is the remedy that the accountant recognizes) ; that he must cut down some unjustified expenses in order that the business may show a profit, or, if necessary, he may urge the client that the business be wound up and that he either start a new business or get out of the line for which he is not qualified. But supposing the client says, "No, I will not do this". I then say that, if the accountant foresees that the client's course will lead to an inevitable disaster, it is up to that accountant to withdraw from the engagement, and I will say further that he should notify the trade of his withdrawal from the engagement.

In the textile trade we have a central spot at which most financial statements can be filed. These financial statements are then photographed and sent out to the subscribers who are interested in obtaining these particular financial statements. In these statements there is always a clause, and most of the houses in our trade have that clause in their financial statements, which reads: "We hereby authorize our accountants to supply you with such information as you request". It is then customary to send a verification blank from the central agency to the accountant, and that, in turn, is photographed and distributed to the interested parties.

This accountant knows that this central point of registration is the place where his expressions of opinion, his statement with regard to his audit, has been filed, and I maintain that it is his duty to notify that central point when he withdraws from an engagement.

At this point let me digress a little bit. I have been talking about what an accountant should do, but a few days ago an accountant came to us and told a

story, not as a matter of complaint, but just "gossiping"—a story that impressed me very much—(this accountant was and is a member of this Society in high standing). He had a client who notified him that his services were no longer required and he was curious to know why; it seems that this client had applied to the bank for a loan and the bank said, "Well, we can put through your loan, I think, if you will take on the firm of 'so-and-so' as your accountants". Now I have no quarrel with either a banker or a merchant insisting upon books being audited by qualified accountants, experienced accountants and those who are familiar with the trade, but in this case, where an experienced and able accountant was displaced, it is for either one of two reasons—either this particular banker had a "fair-haired boy" as his favorite accountant and wanted to see him get lots of business, or else the audit was too good and he wanted some other accountant, who might be more complacent, to render the kind of a report that he would like to place before the Lending Committee, or the Board of Directors; but I will say this— as a merchant and a credit man, I most unreservedly condemn the displacement of a competent accountant just to give the job to somebody's pet.

Now to get back to our theme, the trouble with most business houses when they get into difficulties is, first, either they cannot figure their costs, or they are doing too much volume, or they have too large an overhead, or they are pursuing an unwise selling policy; and (as I said before and must repeat, I believe it the proper thing and the thing that the business community looks to the accountant to do) it is up to the accountant to quit that employment and not have his name associated with it when it comes to inevitable disaster.

Our insistence on this creates a wider field for the accountant. The credit man says, "Why don't you employ a certified public accountant"? or, if one is employed, "Why don't you make semi-annual statements instead of an annual statement"? or, if no profit and loss statement is drawn up, "Why don't you have your accountant draw up this sort of report"? And now, more and more, we are insisting in our trade—and I think it will expand to the other trades if the accountants recognize their opportunity—upon a continuous audit and in that continuous audit we look to the accountant to assume this responsibility.

Many of these audits can be and should be treated just as Francis Bacon said that books should be treated when he said: "Some books are to be tasted, others are to be swallowed and some few are to be chewed and digested". Those few that are to be "chewed and digested" today are those of businesses that require this particular continuous audit.

Now we are not insisting on this continuous audit for the benefit of the accountant. We like to see him get the business, but, like all men, we are primarily selfish—we want that audit so that, instead of giving a man a line of five thousand dollars based on a financial statement that may be five or six months old, we can give him fifteen or twenty thousand dollars on figures that are only one month old and thereby triple and quadruple our sales.

In our own selfish pursuits, if you want to call it that, we can be of vast assistance, as you see, to the accounting profession and, in closing and summarizing, I would say that the opportunity is knocking at your door to make for the accounting profession a larger place in the scheme of things. You will have our support and cooperation and we can make credit granting almost an exact science while giving to the certified public accountant a position that will assure a return to him commensurate with the responsibilities assumed.

Ambit of the Duties and Responsibilities of the Certified Public Accountant

By A. S. FEDDE, C. P. A.

I WISH to say at the outset that when I speak of accountant I refer in each case to the certified public accountant.

We are honored and pleased to have visits from others than accountants, we appreciate the pleasant contacts, we are happy and fortunate to have legal advice,—as we certainly want to keep out of the clutches of both sheriff and jailor,—and we are interested in having the credit grantors tell us what they would like to get in the way of information,—but we are bound to reserve the right to define for ourselves, with some aid from the courts now and then, what the profession of accountancy is, what our own duties are and our responsibilities. The ambit thereof must be known to the accountant even better than to those outside our profession. Those circumstances which create bounds, which circumscribe the activities, create at the same time a frontier to his duties and responsibilities which may be moved forward from time to time, but which, until it is moved forward, constitutes the ambit or boundary and place his duties and responsibilities in a pretty definite position.

He has these duties to his client, to the public consisting of credit grantors, present and prospective investors, and finally to himself.

If one would read a bulletin published by this Society under date of January 12, 1933, on "Classification of Accountancy Services", he would learn that there are many kinds of services rendered by accountants which do not involve any duty whatsoever to the public. Of that nature would be such services as surveys of office or operating procedures, system installations, and special examinations for management purposes only. The last named might include detailed audits for limited periods of cash records, of payroll routine, examinations to locate discrepancies in stock records, and the like. In these engagements he has a duty to his clients to make his presentations in such a manner as will best serve the purpose of the engagement, and a duty to himself to make them in such a manner and in such form that they may not be misunderstood as being anything other than what they are, or covering an examination of any greater scope than that undertaken. In such cases his duty is to his client and to himself only. Such reports being solely for management purposes, and being properly presented as to the scope of the work undertaken and done, the public is not concerned therewith.

In coming to the matter with which the public is most familiar, namely, reports of financial condition and operations with a report on the audit thereof, the public may or may not be concerned, but because such reports are largely submitted by the client to outsiders the accountant must assume that any

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reports of that nature may be so used. However, here again his first duty is to his client, that is, the person who has engaged him to do the work, and his duty to the public is incidental, though essentially real.

Such a report may be made on the basis of an examination limited by his instructions or, though it may not be limited to a certain type of examination, it may be restricted as to some particular—which may be of great importance or it may not. An accountant might be instructed to make a cash audit only, or perhaps a general audit restricted to exclude examination of one or more items, such as the inventory, or the notes receivable, or a particular accruing liability. Sometimes these limitations or restrictions would almost appear to be made in the hope—and even in the expectation—that the accountant would "cooperate" (and I am using quotation marks advisedly) with him and render a report without disclosing the restricted nature of his examination. Naturally, no conscientious accountant would think of rendering a set of financial statements in connection with which his examination had been of a limited sort or if he had been restricted in any way from making the kind of examination which he deemed proper in order to form his opinions as to the fairness of the statements, without disclosing the facts as to the limitation or restriction.

I wonder where the idea originated that a set of statements presented in conjunction with a report signed by an accountant immediately took on a holy estate and was, like Caesar's wife, above suspicion! Is it not a sign of mental laziness on the part of the public when it looks only at an end figure? Or should we flatter ourselves that it is due to the high regard in which the public holds the accountant? The belief seems to be held by a great many that an accountant cannot make a report except on a situation which has his entire approval, and that his signature—no matter what may appear above it—is a guarantee of purity, like the name of a manufacturer on a can of his product. Speaking of duties and responsibilities, the public owes a duty to itself to read the contents of the accountant's report on the statements upon which it is relying. The public—bankers and other credit grantors, as well as investors—may be under the misapprehension that the balance sheet is the work of the accountant, as the can of bicarbonate of soda is the work of the manufacturing chemist; and being the accountant's work, there it stands guaranteed a true statement. Wrong, absolutely wrong! The statement, even if the accountant has assisted in its preparation, is the Company's statement which the accountant has examined in conjunction with the books and supporting data, and upon which he renders an opinion. The accountant may have made suggestions as to desirable revisions in the accounts and statements, which may have been adopted by the Company in full, in part, or not at all. The statements conform or should conform to the books and they may be incorrect in a number of particulars or they may deviate in some degree, possibly of only minor importance, from that recognized as the best accounting practice. The accountant has fulfilled his duty to all concerned when he has

stated his opinion and set out his qualifications, if there are any, and clearly indicated in the latter case, if his report or certificate is not itself entered on the face of the statements, that such statements must be read in conjunction with the notes or report thereon.

There are, however, circumstances under which financial statements are prepared by the accountant under specific instructions to prepare them in such a way that they shall set forth the position and operations as accurately and properly as may be possible, regardless of differences between them and the books. That is decidedly not the ordinary procedure but may be required at times to restate accounts recognized as having been improperly kept, and the report should clearly indicate the nature of the restatement or revision, and whether or not the books have been brought into agreement with the final balance sheet.

An accountant's report may contain qualifications of various kinds; some reports even have a numbered series of qualifications! It seems silly, therefore, that the public should ever fail to give due consideration to such matters. Whenever an accountant's report or certificate contains the words "subject to" then it is the time and place to stop and investigate, if a knowledge of the situation is of any importance. The more I consider it, the more convinced I am that the misconception that an accountant does not submit a set of financial statements with his report unless he believes they are correct, arises from the belief that they are the accountant's statements instead of being, as they are in all but special cases, the statements of the Company upon which the accountant is reporting.

The accountant does not issue a policy of insurance nor a guaranty of title. He is not a public appraiser—that is, in the profession of making physical valuations of assets.

There is no recognized school of accountancy which includes a course in its curriculum offering training in the recognition of grades of goods and in their physical appraisal. There may be among accountants some who happen to be qualified to act as appraisers of certain goods. If they do so, the acts are not those of an accountant, as an accountant has no duty or responsibility with respect to the physical presence or value of assets, but only with their presence and value as ascertained by documentary and other accounting evidence. I do not contend that it might not be of use to the accountant at times to make some inspection of stock for certain purposes, but that would merely be of collateral value to him and should not fix responsibility on him as a valuer or appraiser.

In his application of audit procedure, which includes interrogation of management and employees, the ownership and value of such an item as the inventory is confirmed to the accountant's satisfaction. If there has been fraudulent removal of goods it may or may not be discovered through audit (the accountant is not a police officer or private detective)—on the other hand, if there has been fraudulent borrowing of goods, that fact may not be discovered through an appraisal.

The accountant is skilled in accounts,—their construction, verification, classification, interpretation and presentation,—and if his activities pass the bounds of accountancy and appear to encroach on the proper activities of other callings he may be assuming responsibilities that need not be his as an accountant.

It has come to be recognized that the accountant's contact with the financial and other affairs of concerns engaged in many different kinds of undertakings has afforded him the opportunity to acquire a broad view of business and an experience probably impossible to have in any other profession or activity. Perhaps with that in mind, bankers have asked, can an accountant prepare business budgets? The answer is that no one is more fitted to do it. However, he cannot certify to an estimate or render an opinion that a future result indicated by the budget will eventuate. The preparation of a business budget is a composite task requiring the cooperation of many people and, if intelligently and honestly compiled, is of great value in verifying and promoting the progress of an enterprise. The accountant can say that care has been used in its preparation and that the estimated results are reached by the use of the best information available and that sound accounting principles have been employed in its preparation,—the calculations, however, being based on certain assumed premises. The assumptions will be based on the carrying out of proposed controlled actions, such as dividends and executives' salaries to be paid, and that conditions less under control will be realized, such as the assumed sales volume, labor cost, material cost and use of money cost. Reliance on the budget by others can only be to the extent that they believe the probabilities and possibilities set out are reasonable of realization.

There are diehards and standpatters who maintain that an accountant must concern himself only with accomplished facts. There are some that will have nothing to do with futures—and to them this is heresy; there are always those who disapprove of anything that has a semblance of progress. The accountant's frontiers have been pushed forward and his responsibilities increased. I agree that the accountant must not prophecy, but I thoroughly disagree with the idea that he must use only language phrased in the past tense. If that were so, a most useful aid would be denied to management. He must, however, be so guarded in his statements, and so clear in his expressions that he cannot justly be accused of using vague terms from which improper inferences may be drawn.

The question often comes up as to how much information the accountant shall present. Here again may I say that in many cases the accountant is not given a free hand and a company's statements submitted to the public with the accountant's report may be meagre and severely condensed. Here, as well, the accountant must, obviously, render an honest opinion with any important qualifications stated. In the case of the large companies listed on national exchanges, further information than contained in the condensed pub-

lished reports is on file with the Securities and Exchange Commission so that far more information is available than the average investor cares to read. With respect to smaller concerns which numerically far outnumber the large listed ones, and which are more subject to examination for ordinary credit risks, the accountant seeks to report on all matters pertaining to the accounts that will assist in forming an opinion as to the credit risk. Within the limits of an audit engagement the accountant, obviously, cannot compile the data that is required in a registration statement. He is, therefore, guided by his judgment and, within the limits of his instructions, submits as comprehensive a view of the client's affairs as possible.

In carrying out his duties the accountant must not be grossly negligent. That is a purely negative and legalistic statement. In my acquaintance with the work of accountants my experience has been that, as a class, they take every precaution that seems proper to do their work in such a manner as to avoid being chargeable with negligence, and on the contrary to gain reputations for great care, diligence and skill. I do not believe accountants as a class are specially concerned with merely remaining on the safe side of the law—they are chiefly concerned with rendering the best service possible and rendering it in such a way that negligence could not become chargeable except through a train of extraordinary circumstances. They feel themselves charged with moral obligations far beyond the obligations imposed by law.

With his knowledge of accounts, his experience, and his use of suitable audit procedures, the accountant reaches his conclusions and opinions. When these are intellectually honest, based on sound judgment, and adequately presented, he has fulfilled his duty to his client and to the public.

As to the accountant's duty to himself—when at the end of the day's work he can say—"I have done my work to the best of my ability; I have not compromised with my well considered opinions"—then I should say he has fulfilled his duties and obligations as an accountant to himself.

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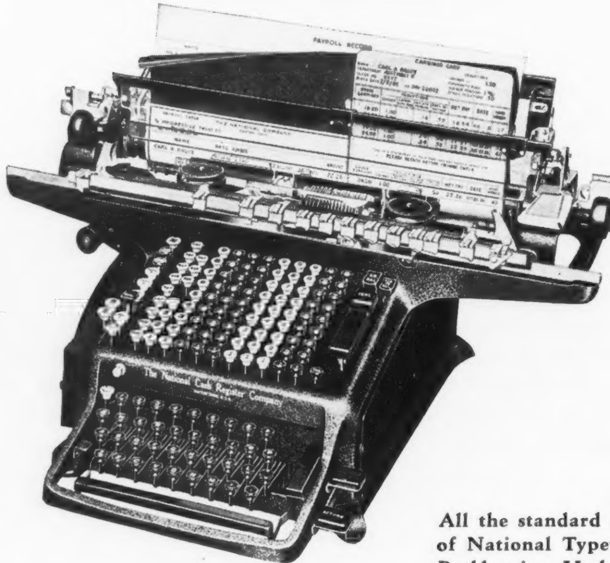

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